European Economy Seminar – Exam 17th January 2017

Basic solution guidelines (please note that in the exam, additional development on each topic was warranted)

1) *A strong protectionist rhetoric has recently erupted in several EU member countries and abroad.*
a) Briefly characterize the existing paradigm for the international organization of production.
b) What are the impacts of this reality in economic indicators and how does it impact on the EU integration project?
c) Comparing with EU countries, China was a latecomer to the world trade system but caught up fast. What are its' strong points and challenges?

a) 40% Global value chains (GVCs) stand as the paradigm for production. Production is fragmented along different locations and the final value of the good/services results from value added in each stage.

b) 30% The analysis and the indicators based on gross trade flows should be replaced by flows of value added. For example, exports embody a large share of foreign value added. In addition, bilateral trade balances are not informative. Moreover, GVCs increase the interdependence between economies and resilience to shocks becomes a major concern.

GVCs have a regional character, thus they have led to deeper integration in the EU. However, tensions may arise because countries are placed in different segments of the chain (with different value added creation), thus external imbalances may arise and persist.

c) 30% China shows as main strong points the still relatively low labor costs, the growing internal market, the open attitude towards foreign trade and investment and improving infrastructure. As for main challenges, the high private indebtedness, the environmental conditions and the inefficiency in the allocation of resources, can be referred.

2*) The crisis in the euro area after 2010 has been attributed to a sudden-stop of external financing to some economies.*
a) Briefly explain what drives a current account imbalance and later a financing crisis.
b) Why is it so difficult to solve such a problem within the setup of a monetary union?
c) What should EU policy-makers do to avoid the repetition of the latest crisis?

a) 40% The current account balance is described by the fundamental identity of macroeconomics (S-I)+(T-G)=(X-M), stating that the government balance, savings rates and investment levels may lead to external financing that accumulates into external debt. When foreign investors realize that indebtedness is too high, given the foreseeable GDP growth rates and/or an international shock takes place, they stop financing (sudden-stop). The subsequent financing problems increase distrust and turn additional financing becomes even harder to obtain.

b) 30% In a monetary union the absence of exchange rate policy does not allow for a depreciation that triggers and expenditure switching towards exports (and a contraction of imports). Moreover, the absence of automatic stabilizing mechanisms in the monetary union, such as common unemployment subsidies or other federal fiscal policies, turns the situation worse. The loop between the sovereign debt and the domestic banking systems is also a major disturbing factor. Therefore, countries are forced to adopt very stringent expenditure reducing policies, which create recessions and lead to lower wages and lower inflation. The negative side effects on the solvency of the banking system (through more non-performing loans) and in the government balance may create a recessionary loop. Only positive supply-side elements assure a lasting rebalancing and growth.

c) 30% EU decision makers should work to accelerate structural reform in Member-countries and other supply-side aspects, while increasing the screening and enforcement of fiscal rules and the broad correction of macroeconomic imbalances. In parallel, the creation of EU wide risk sharing mechanisms is warranted (banking union, fiscal federalism)

3) *Monetary policy, financial markets and banks are closely interlinked and also interact with real economic activity.*
a) What is presently the stance of the monetary policy in the euro area and how does it impact on European banks and financial markets?
b) What are the challenges that ECB and EU governments need to overcome in these dimensions?
c) How do you assess the role of the initiated Banking Union?

a) 40% The stance of monetary policy in the euro area has been accommodative, with interest rates very close to zero and the implementation of several non-conventional monetary policy measures (QE), in order to inject liquidity in the economy and to reduce financing pressures of more vulnerable countries.

The low interest rate environment (LIRE) can undermine banks' profitability, given deposit rates downward rigidity. Low interest rates can also provide an incentive for investors to search for more risky assets in order to obtain higher returns (*search for yield phenomena*), giving rise to market instability and to the risk of the emergency of speculative bubbles.

b) 30% While helpful in containing pressures in money markets in the aftermath of the financial crisis, monetary policy was less effective in promoting the recovery of economic activity. In addition, several euro area countries are still experiencing financing difficulties, as evidenced by interest rates differentials with respect to Germany.

European governments face the challenge of implementing sound fiscal policies and structural reforms, as monetary policy needs to be complemented with these policies in order to be effective in restoring growth conditions. The challenge of the ECB is to exit from the current policy stance (e.g. rising inflationary pressures in Germany may force a reversal of its current stance) without causing financing difficulties in more vulnerable euro area countries.

c) 30% The Banking Union, by reducing financial market fragmentation and the bank-sovereign loop, could, if completed, help reduce financing pressures in some countries financial systems. However, the sovereign-bank risk link can only be reduced if the SSM is complemented with common deposit insurance and resolution funds (otherwise banks would still rely on national authorities to be bailed out).

4) The diplomatic and political relations between European countries, and also with foreign powers, have always strongly shaped the progress of the EU integration project.

a) To what extent is Brexit understandable in light of episodes that took place since the fifties?
c) How do energy and migration challenges relate with EU-countries foreign policies?
c) Why is political stability relevant for productivity and growth developments?

a) 30% The UK has always been a reluctant EU member. It did not take part of the group of founding countries, sponsored the alternative project of the European Free Trade Association, it has asked for specific compensation on losses on Commonwealth trade and it did not participate in the monetary union. Therefore, although UK was not hit too severely by the euro crisis, Brexit does not come as a full surprise in historical terms.

b) 40% Energy is crucial for economic activity and countries that do not have endowments of primary energy sources must assure a constant foreign supply (energy security). As for Europe this involves negotiations with Middle-East countries, North of Africa and Russia, as well as investments in renewables and removal of distortions in the internal market. As for migration, it can be considered as a population ageing mitigating factor and work as an adjustment mechanism within the monetary union (labor flowing to regions growing fast and possible remittances following to origin countries) but, especially with refugees, there is a cost associated with integration that involves a political dimension. EU countries face different situations but the multinational dimension of the issue would advise for full cooperation.

c) 30% Political stability (internal and external) is important for economic growth and productivity because it facilitates the implementation of structural reforms, the coordination of policies and approval of reforms needed in the EU, it promotes investment (also FDI) and mitigates the volatility in financial markets.